



INFORMATION REPORT

TO: Chair and Members Audit, Finance and Administration Committee	WARD(S) AFFECTED: CITY WIDE
COMMITTEE DATE: December 9, 2013	
SUBJECT/REPORT NO: Restructured Master Asset Vehicle (MAV) Notes and Asset Backed Commercial Paper (ABCP) Update (FCS11006(c)) (City Wide)	
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SIGNATURE:	

Council Direction:

Not Applicable.

Information:

The highlight of this update is the sale of the City’s Master Asset Vehicle II (“MAVII”) Notes. On October 4, 2013, the City’s entire holdings with a par value of \$75,664,883 of MAVII Notes in the Reserve Fund were sold through the public bond market. On settlement, proceeds from sale of \$67,430,945 result in a realized capital loss of \$8,303,070 and a net capital recovery of \$4,593,930 when a valuation write-down of \$12,897,000 from 2007 is taken into consideration.

The completion of the amendment process on October 2, 2013 allowed for an optional auction-based redemption process (the “Redemption Unwind”) for MAVII Notes. The Redemption Unwind was determined to be a less desirable alternative to the sale through the public bond market.

In addition, the City received a payment of \$47,965 from Deutsche Bank representing the City’s pro rata share of a larger settlement reached between Deutsche Bank and

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Investment Industry Regulatory Organization of Canada (IIROC) in connection with Deutsche Bank's sale of Aurora Trust (sponsored by Coventree Financial). The City's original holding in Aurora Trust of \$4,960,000 was subsequently folded into the MAVII Notes as restructured asset backed commercial paper (ABCP) in 2009.

As a result of the MAVII Note sale, Devonshire Trust with original cost of \$9,919,000 and write-down of \$5,500,000 taken in 2007 constitutes the only ABCP owned by the City. Although the City's independent litigation has been terminated, due to external legal counsel error, there is another ongoing action which could result in recovery. Barclays Bank is involved in litigation against Metcalfe and Mansfield (custodian) in order to realize on collateral which is in the Bank of New York. The trial judgment was favourable to note holders, as was an appeal to the Court of Appeal. However, Barclays is currently seeking leave to appeal to the Supreme Court of Canada. If Barclays is not successful at the Supreme Court, note holders would likely receive a significant recapture on these notes. As it concerns the City of Hamilton's holdings, the current book value net of the write-down is \$4,419,000 and the recapture with accrued interest (less trustee and administration fees, expenses and mounting legal costs, etc.) will likely be an amount between the current book value and the original cost.

Table 1 – Summary of MAVII Notes and Devonshire Trust ABCP

Description	Credit Rating	Par Value Oct. 4/13	Attributed Book Cost Sep 30/13	Forecast @ 98% in 2017	Sale Proceeds Oct. 11/13
MAVII STRIP					
MAVII CL A-1	AAL	\$41,112,934	\$41,153,651		\$37,268,666
MAVII CL A-2	AL	\$27,067,847	\$27,090,099		\$24,060,201
MAVII CL B	-	\$4,913,566	\$4,917,608		\$4,250,726
MAVII CL C	-	\$2,264,789	\$2,266,868		\$1,817,720
Total STRIP Value		\$75,359,136	\$75,428,226	\$73,851,953	\$67,397,313
MAVII CL 13	-	\$305,747	\$305,789	N/A	\$33,632
Total MAV II NOTES		\$75,664,883	\$75,734,015	\$73,851,953	\$67,430,945
Devonshire ABCP	-	\$10,000,000	\$9,919,000	N/A	N/A

Notes to Table 1:

1. Par value and attributed book cost do not include write-downs for MAVII notes of \$12,897,000 and Devonshire of \$5,500,000.
2. In June 2013, DBRS upgraded MAVII CL A-2 Notes to "A (low)" from "BBB (High)".

Reason for the Sale of the MAVII Notes

The sale of the MAVII Notes was executed opportunistically at a price slightly above \$0.89 per \$1 for a MAVII STRIP and in advance of implementation of the Redemption Unwind. With intent to reinvest the proceeds, the sale was assessed to be superior for the City’s Reserve Fund to either holding the MAVII Notes until 2017 or participating in a future redemption through the Redemption Unwind process.

The sale of the MAVII Notes crystallized a capital loss of \$8.3 million. However, Table 2 shows that 72% to 90% of the capital loss can be regained from the reinvestment interest of \$6 million to \$7.5 million by reinvesting the proceeds of \$67.4 million for 4 to 5 years given current yield conditions at 2.1%. This gives a total reinvested value of \$73.4 million for a 4-year scenario and \$74.9 million for a 5-year scenario.

Table 2 – Analysis Based on Reinvestment Rate of 2.1%

All amounts in millions \$	4-year Term	5-year Term
Proceeds	\$ 67.4	\$ 67.4
Reinvestment Interest	6.0	7.5
Total Reinvested Value	73.4	74.9
Cost (Attributed Book Cost)	75.7	75.7
Total Reinvested Value Less Cost	(2.3)	(0.8)

These reinvestment outcomes were compared with the alternative of holding the MAVII Notes until 2017 and assuming 98% recovery. From Table 1, the value of the MAVII Notes in 2017 would be \$73.8 million. In the 4-year reinvestment scenario above, the total reinvested value of \$73.4 million is *less than* the MAVII value in 2017 of \$73.8 million by \$0.4 million. However, in the 5-year reinvestment scenario above, the total reinvested value of \$74.9 million is *greater than* the MAVII value in 2017 of \$73.8 million by \$1.1 million. This result reinforces the assessment that selling and reinvesting is worthwhile.

In summary, selling the MAVII Notes and reinvesting proceeds according to the City’s Statement of Investment Policies and Procedures gives an outcome with an acceptable economic recovery in exchange for important advantages for the Reserve Fund including:

- The MAVII notes are replaced with eligible investments (e.g. senior bank, government bonds), which have significantly higher credit quality, liquidity and safety of principal. This upgrades the overall quality of the Reserve Fund.
- The Redemption Unwind process is avoided if the City needed to redeem prior to 2017. This complex process has considerable administrative and legal requirements. Moreover, ultimate proceeds received through this process may

be materially less than expected due to swap unwind costs, fees, expenses, liquidation of unwind collateral. In contrast, proceeds from a sale in the public bond market (through which the City's sale was done) are agreed to and known by both the buyer and seller.

- The numerous risks associated with the MAVII notes, including recovery, credit, market, and term-extension, are avoided. Currently, a significant risk of recovery exists for the Class C Notes. A negative credit event between now and 2017 could jeopardize the 98% forecast for recovery. MAVII Notes also carry term-extension risk in that some of the assets may not mature in 2017.
- The capital which was previously tied up in the MAVII Notes can, upon sale, be allocated more efficiently to take advantage of opportunities in the market (e.g. investing in equities or extending term to maturity) which may lead to better overall returns for the Reserve portfolio.

Reinvestment of proceeds of sale

The City has reinvested \$38.2 million of the \$67.4 million in proceeds in eligible fixed income investments with a weighted average term of 5.3 years and a weighted average yield of 2.7% during the period between the date of sale, October 4, 2013, and the time of writing this report. Reinvestment of the remaining proceeds will be made in eligible investments, including the ONE Equity Fund, partly for diversification but primarily because return expectations for the Canadian equity market over the next four years are a minimum of 3%.